



THE CHAIRMAN

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

June 22, 2001

The Honorable John D. Dingell  
Ranking Member  
Committee on Energy and Commerce  
U.S. House of Representatives  
Room 2322, Rayburn House Office Building  
Washington, D.C. 20515-6115

The Honorable Edward J. Markey  
Ranking Member  
Subcommittee on Telecommunications and the Internet  
U.S. House of Representatives  
Room 2018, Rayburn House Office Building  
Washington, D.C. 20515-6115

The Honorable Edolphus Towns  
Ranking Member  
Subcommittee on Commerce, Trade, and Consumer Protection  
U.S. House of Representatives  
Room 2232, Rayburn House Office Building  
Washington, D.C. 20515-6115

Dear Congressmen Dingell, Markey, and Towns:

In a letter dated February 5, 2001, you asked what measures the Commission, self-regulatory organizations, and day-trading firms have undertaken regarding the questionable practices identified in the U.S. General Accounting Office's ("GAO") report, Securities Operations: Day Trading Requires Continued Oversight (February 24, 2000) and the Commission staff's Report of Examinations of Day-Trading Broker-Dealers (February 25, 2000).

I am pleased to submit the enclosed progress report in response to your letter. If you have any questions or comments, please do not hesitate to contact Lori A. Richards, Director of the Commission's Office of Compliance Inspections and Examinations, at 202-942-7400.

Sincerely,

A handwritten signature in black ink, appearing to read "Laura S. Unger".

Laura S. Unger  
Acting Chairman

Enclosure

cc: The Honorable W. J. "Billy" Tauzin, Chairman  
Committee on Energy and Commerce

Report in Response to  
Congressmen Dingell, Markey, and Towns'  
Letter of February 5, 2001  
Regarding Efforts to Address  
Questionable Practices at Day-Trading Firms

The U.S. Securities and Exchange Commission ("SEC") has continued to focus on firms that offer day-trading services to the public. This report describes recent examination, regulatory, and enforcement efforts involving day trading.

1. Examination Oversight

After the SEC staff completed its initial examination sweep of 47 firms offering day-trading services and reported the findings (Report of Examinations of Day-Trading Broker-Dealers, February 25, 2000), securities regulators have continued to conduct examinations of day-trading firms. SEC, NASD Regulation, Inc. ("NASDR"), and the Philadelphia Stock Exchange ("PHLX") staff have conducted additional examinations to ensure that all known day-trading firms have been examined and have conducted follow-up examinations to determine whether earlier examination findings have been corrected.

As of the time of our public report, there were approximately 133 day-trading firms. All of these firms were examined by the SEC or by a securities self-regulatory organization ("SRO"). SEC and NASDR staff estimate that currently there are approximately 141 firms that promote day-trading services to the public.

The SEC, in conjunction with the NASDR and PHLX, conducted follow-up examinations of 48 day-trading firms. These examinations revealed violations of margin rules (*i.e.*, unlawful lending practices, inadequate lending disclosure), short sale rule violations, misleading advertisements, and net capital deficiencies, though with less frequency than in previous examinations. Other violations detected were of SRO and SEC rules related to supervision (*i.e.*, inadequate written supervisory procedures, failure to enforce supervisory procedures), maintenance of books and records (*i.e.*, missing customer account information), and the calculation of net capital.

During 2001 and 2002, SRO staff will continue to conduct routine examinations of existing day-trading firms and of newly registered day-trading firms to determine compliance with applicable securities rules. In addition, SEC staff will initiate cause examinations when appropriate.

2. Day-Trading Firms are Subject to New Regulatory Requirements

Firms that offer day-trading services to the public have become subject to several new or amended rules. Effective October 16, 2000, NASD member firms promoting a day-trading strategy are required to provide a risk disclosure statement to all new non-institutional customers prior to opening an account.<sup>1</sup> The risk disclosure statement must

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<sup>1</sup> See NASD Rule 2361.

include the following statements: day trading can be extremely risky; be cautious of claims of large profits from day trading; day trading requires knowledge of securities markets; day trading requires knowledge of a firm's operations; day trading will generate substantial commissions, even if the per trade cost is low; day trading on margin or short selling may result in losses beyond your initial investment; and potential registration requirements. New NASD rules also require that firms promoting a day-trading strategy must make a determination whether, in light of the risks, a day-trading strategy is appropriate for the particular customer.<sup>2</sup> The NASDR reports that in its routine examinations of day-trading firms conducted since these new rules became effective, it has found most firms to be in compliance with the new rules.

In addition, the PHLX amended its rules on August 20, 1999 to require all off-floor traders associated with its member firms to pass the Series 7 licensing examination.<sup>3</sup> PHLX reports that most of its member firms have been in compliance with the rule since its effective date.

More recently, the SEC approved changes to NASD and New York Stock Exchange ("NYSE") rules governing margin requirements for day trading.<sup>4</sup> The amendments established special maintenance margin and minimum equity requirements, and imposed buying power limitations and other restrictions, for customers who engage in a "pattern" of day trading.<sup>5</sup> Specifically, the amended rules more adequately address risks associated with pattern day trading by: requiring that a pattern day trader deposit minimum equity of \$25,000 on any day in which the customer day trades; limiting the buying power of pattern day traders who incur a day-trading margin call; prohibiting the use of cross-guarantees to meet day-trading margin requirements; and requiring that funds used to meet day-trading margin requirements remain in the customer's account for two business days following the close of business on any day when the deposit is required.<sup>6</sup> The effective dates for the NASD and NYSE rule amendments are September 28, 2001 and August 27, 2001, respectively.

Finally, full implementation of decimalization for listed and over-the-counter equity securities was completed on April 9, 2001. The SROs are currently in the process of evaluating the impact of decimalization on the securities markets. The SEC has

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<sup>2</sup> See NASD Rule 2360. In making a determination, the member firm is required to ascertain the essential facts relative to the customer, including: investment objectives; investment and trading experience and knowledge; financial situation; tax status; employment status; marital status and number of dependents; and age.

<sup>3</sup> See PHLX Rule 604.

<sup>4</sup> SEC Release No. 34-44009; File Nos. SR-NYSE-99-47 and SR-NASD-00-03 (February 27, 2001).

<sup>5</sup> *Id.* The amended rules define a pattern day trader as a customer who executes four or more day trades within five business days, unless the number of the customer's day trades is six percent or less of their total trades for that period.

<sup>6</sup> *Id.* See also NASD Notice to Members 01-26.

directed the SROs to submit studies by September 10, 2001 regarding the impact of decimal pricing on systems capacity, liquidity, and trading behavior. SEC staff plans to continue to work with the SROs to assess the impact of decimal pricing on the efficiency and integrity of the markets. Based on that assessment, the SEC will consider what, if any, further regulatory action is necessary.

### 3. Enforcement Actions

The SEC has brought several enforcement actions related to day trading.<sup>7</sup> Most recently, on June 13, 2001, the SEC instituted and simultaneously settled public administrative and cease and desist proceedings against **JPR Capital Corporation** ("JPR Capital"), a New York-based day-trading firm, JPR Capital's owner and president, JPR Capital's Chief Operating Officer, a former co-owner of JPR Capital, and a former registered representative of the firm.<sup>8</sup> The administrative proceedings found that JPR Capital violated, among other things, the rules and regulations governing the extension of margin loans to customers established by the Securities Exchange Act of 1934 ("Exchange Act") and the Board of Governors of the Federal Reserve System ("Federal Reserve Board"). All of the respondents consented to the SEC's order without admitting or denying the SEC's allegations, agreed to pay civil money penalties, and consented to other relief. JPR Capital was censured, ordered to pay a civil money penalty of \$55,000, and ordered to cease and desist from committing or causing any violations and any future violations of Sections 7(c), 17(a) of the Exchange Act, Rule 17a-4 hereunder, Rule 10b-16 under the Exchange Act, and Regulation T promulgated by the Federal Reserve Board. In addition, JPR Capital was ordered to comply with undertakings designed to improve JPR Capital's compliance department. The individual respondents were censured and ordered to pay civil money penalties of \$5,500, and to cease and desist from committing or causing violations of certain provisions of the securities laws.

The SEC found that JPR Capital's day traders conducted all of their day trading in margin accounts, which allowed the day traders to purchase securities with funds borrowed from the broker-dealer. There are, however, limitations on the extension of margin account loans by a broker or dealer or their associated persons. Specifically, Sections 7(c) and 7(d) of the Exchange Act and Regulation T promulgated by the Federal Reserve Board prohibit brokers or dealers, or their associated persons, from, among other things, extending or maintaining credit to or for any customer except as prescribed by the Federal Reserve Board in Regulation T. The SEC found that the actions of JPR Capital and other of the respondents allowed JPR Capital's day-trading customers to continue trading when positions in their margin accounts would otherwise have, and should have,

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<sup>7</sup> See In the Matter of All-Tech Direct, Inc., SEC Release No. 34-42446, Admin. Proc. File No. 3-10150 (February 22, 2000). See also In the Matter of Investment Street Company, Dynamic Trading of Miami, Inc., Emilio Sardi, and Javier Saenz, SEC Release No. 34-42447, Admin. Proc. File No. 3-10151 (February 22, 2000).

<sup>8</sup> See In the Matter of JPR Capital Corp. et al., SEC Release No. 34-44413, Admin. Proc. File No. 3-10505, (June 13, 2001) and In the Matter of Jeffrey Ramson, SEC Release No. 34-44412, Admin. Proc. File No. 3-10504, (June 13, 2001).

been liquidated. In addition to the margin lending violations, the SEC found that JPR Capital violated credit disclosure, and books and records provisions of the Exchange Act.

On June 13, 2001, the SEC also settled its previously instituted proceeding against **All-Tech Direct, Inc.** ("All-Tech"), a day-trading firm, and certain of its employees, for extending short-term loans to customers in excess of the limits allowed under the federal margin regulations.<sup>9</sup> The SEC censured All-Tech and ordered the firm to cease and desist from committing or causing any violations of the federal margin lending rules, to pay a \$225,000 civil penalty, and to retain an independent consultant to review and recommend improvements to its margin lending practices. The settlements against the individuals include, among other relief, suspensions and civil money penalties.

The administrative proceeding, instituted on February 14, 2000, alleged that All-Tech improperly used funds from accounts of persons associated with the firm to make loans to its customers to enable the customers to meet margin calls, and that a number of All-Tech employees aided and abetted, and caused, All-Tech's improper conduct. In its settlement, All-Tech consented to the entry of an order, without admitting or denying the findings contained in the order, in which the SEC found that All-Tech made approximately 100 improper margin loans totaling approximately \$3.6 million over an eight-month period in violation of federal margin lending rules. The SEC previously settled with three other individual respondents, so the settlements announced on June 13, 2001 completely resolved the case.

The NASDR has also brought several enforcement actions against firms that provide day-trading services for misleading advertisements, improper lending and margin practices, supervisory deficiencies, improper short selling, registration deficiencies, misrepresentations to customers, and the misuse of customer funds.<sup>10</sup> Most recently, the NASDR censured and fined All-Tech \$250,000; and fined and suspended several individuals associated with the firm for violations of the federal margin regulations and SRO advertising rules.<sup>11</sup> In addition, the NASDR settled enforcement actions against five day-trading firms, including the expulsion of Landmark Securities Corporation, for

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<sup>9</sup> See In the Matter of All-Tech Direct, Inc., et al. SEC Releases Nos. 34-44415, 34-44416, 34-44417, 34-44418, 34-44419, Admin. Proc. File No. 3-10150, (June 13, 2001).

<sup>10</sup> See "NASD Regulation Sanctions Providential Securities, Inc. and Bars Principal, Henry Fahman" (December 15, 2000). "NASD Regulation Charges All-Tech, Houtkin, and Others With Day Trading and Advertising Violations" (July 17, 2000). "NASD Regulation Files Action Against Day-Trading Firm for Registration and Supervisory Violations" (July 17, 2000). "NASD Regulation Announces Eight Day-Trading Enforcement Actions" (February 24, 2000). "NASD Regulation Censures and Fines On-Site Trading, Inc. For Registration Violations" (July 7, 1999). Available at [http://www.nasdr.com/press\\_frame.htm](http://www.nasdr.com/press_frame.htm).

<sup>11</sup> See "NASD Regulation Fines All-Tech, Houtkin, and Other Execs \$380,000 for Day Trading and Advertising Violations; Suspends Individuals" (June 13, 2001). Available at [http://www.nasdr.com/press\\_frame.htm](http://www.nasdr.com/press_frame.htm).

short sale rule violations, improper loans to customers, supervisory deficiencies, misleading advertisements, and registration violations.<sup>12</sup>

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<sup>12</sup> See "NASD Regulation Settles Five Disciplinary Actions Involving Day Trading" (June 7, 2001). Available at [http://www.nasdr.com/press\\_frame.htm](http://www.nasdr.com/press_frame.htm). (The five day-trading firms are Landmark Securities Corporation, Momentum Securities, LLC, CyBerBroker, Inc., Cornerstone Securities Corporation, and Summit Trading, Inc.)